

Testimony Concerning
Auction Rate Securities Markets

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Chairman Frank, Ranking Member Bachus, and Members of the Committee:

I am Susan Merrill, Executive Vice President and Chief of Enforcement at the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today. We at FINRA have been actively involved in monitoring and working to resolve the issues relating to auction rate securities (ARS). From our examination staff to our enforcement team to our arbitration forum and investor education group, we have devoted staff from all parts of our organization to produce a comprehensive and integrated response to the recent challenges in the auction rate securities markets.

Along with our regulatory counterparts here today, FINRA is committed to continue working on these important issues, and we share the Committee's interest in holding industry participants accountable and providing investors with real and tangible relief.

FINRA is the largest non-governmental regulator for all securities firms doing business in the United States. FINRA was created in 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration divisions of the New York Stock Exchange. FINRA touches virtually every aspect of the securities business—registering and educating all industry participants, examining securities firms; writing rules; enforcing those rules and the federal securities laws; informing and educating the investing public; providing important utilities, and administering the largest dispute resolution forum for investors and registered firms. All told, FINRA oversees 5,000 brokerage firms, about 172,000 branch offices and more than 676,000 registered securities representatives.

Enforcement Inquiries

In late February of this year, required regulatory filings with FINRA showed an increase in the number of complaints that broker-dealers were receiving regarding auction rate securities. In response, FINRA conducted a survey of more than 200 firms regarding their holdings of auction rates securities, both in proprietary and customer accounts. FINRA used the information gathered through that survey to inform our approach and next steps in addressing the problems that were occurring for auction rate investors.

In early spring, after consulting with the SEC in order to avoid any duplication of efforts, we sent out a sweep letter to two dozen firms. In its sweep letter, FINRA's Enforcement Department sought information concerning firms' auction-rate securities sales practices, including the firms' role as dealers in the auction rate marketplace, as well as their use of

sales and marketing materials, their supervision of the activities of firm employees in the auction rate market, and the firms' overall supervisory systems and controls as they relate to these issues. The firms that received the letters were in most instances "downstream" firms, which are firms that were not involved in the underwriting or management of the auction process but rather served as distributors placing bids on behalf of their customers at the point of sale.

The rationale behind our selection of firms was to avoid duplication with other regulators and to reach a broad range of firms with the most significant auction rate distribution activities—including those firms that had been the subject of auction rate-related customer complaints. Most importantly, we wanted to ensure that the largest possible number of investors had an opportunity to benefit from our efforts.

Following these initial actions, FINRA re-surveyed firms in July regarding auction rate holdings in customer and proprietary accounts, and our Enforcement staff sent a second sweep letter to more than a dozen firms in August. Using our internal data, the Enforcement staff has continued to identify additional firms for investigation and follow-up on-site examinations. These sweeps, together with additional referred matters, have resulted in the opening of nearly 50 enforcement inquiries, many of which are ongoing. The focus of our inquiries relates to, among other things, auction rate marketing materials and advertising communicated by the firms to its customers; supervisory issues surrounding the purchases and sales of such securities; as well as possible conflicts of interest where a firm may have been in possession of knowledge about ARS failures and

liquidated their proprietary ARS positions by selling those positions to customers or ahead of customer liquidations.

Unlike traditional industry sweep investigations, our follow-up requests to the original sweep firms as well as the requests to newly identified firms have called for the firms to produce additional categories of information for on-site inspections by the Enforcement staff. To date, 53 FINRA staff members have conducted approximately 32 on-site examinations of firms located in more than a dozen states; additional on-site examinations are continuing as we sit here today. The purpose of these visits has been to engage in “real time” enforcement inquiries in which we analyze firm data produced at the firm and interview firm employees about this data as well as other issues on-site. This has enabled Enforcement staff to get a faster and better understanding of firms’ ARS activities. We continue to pursue these on-site exams both to ensure we expediently address the issues at hand and to send the message to the industry that we are and continue to be focused on ensuring that customers are treated appropriately.

We also continue to explore how we can utilize our regulatory resources to enhance our examination program for these issues. For example, as a result of recent events, we are expanding our regular examination procedures to include a more detailed analysis of auction rate securities. In the past several months, our financial and operational examiners have focused on the valuation of ARS held in securities firms’ proprietary accounts. In addition, we have worked closely with the SEC to require firms to hold more capital for these securities in view of the illiquidity in the market. We have also

increased margin requirements due to the lack of marketability of these instruments.

Sales practice examiners are reviewing customer disclosures as well as presentation of auction rate securities on customer statements and redemption practices.

Enforcement Actions

We anticipate announcing very shortly agreements in principle with several firms for violations relating to the manner in which firms sold ARS using advertising or marketing materials that were not fair and balanced and did not provide a solid foundation for evaluating the facts regarding purchases of ARS; as well as for supervisory violations relating to the firms' failure to establish and maintain a system reasonably designed to achieve compliance with FINRA rules surrounding the sale of these products. Most importantly, FINRA is focused on restoring funds to customers.

In any settlements, our primary motivation is to ensure that the firms will offer to purchase from all investors in the relevant class at par ARS that are subject to auctions that have not been successful as of the date of the settlement and are not subject to current calls or redemptions. We at FINRA think that by expanding our scope beyond those firms that the SEC was rightly focused on, we will be able to protect additional investors and restore funds to a broader span of customers. As for those firms that choose not to resolve the regulatory investigations and offer to buy back ARS sold to their clients, we will continue investigating aggressively with a view to bringing enforcement actions as appropriate for ARS-related misconduct and any other violative conduct that is identified.

Regulatory Guidance

FINRA has also been active in issuing Regulatory Notices regarding auction rate securities. These Notices provide guidance to securities firms on how FINRA rules apply with regard to auction rate securities, and often focused specifically on procedures that enhance customer protection. For example, in April, FINRA issued a reminder (Regulatory Notice 08-21) to firms that when allocating partial redemptions of auction rate securities among their customers, they must adopt procedures that are reasonably designed to treat customers fairly and impartially, and must put their customers' interests ahead of their own. For instance, if a redemption is offered that is favorable to holders of a particular auction rate security, firms are prohibited from redeeming positions in its proprietary accounts before all of its customers' positions have been redeemed.

In June, FINRA provided guidance (Regulatory Notice 08-30) to firms on obligations that may arise in connection with customer requests to sell generally illiquid securities and informing customers of buy interest in such securities. This guidance served to enable and speed the process for investors wishing to sell their holdings in auction rate securities to buyers who were willing to purchase them at a discount.

FINRA also notified firms (Regulatory Notice 08-17) that they should begin utilizing three new product categories in reporting customer complaints relating to auction rate securities, allowing us to better track those complaints.

Investor Education

In addition to the integrated regulatory, examination and enforcement initiatives outlined above, we at FINRA strongly believe that effective investor protection begins with education. This is why, on March 31st of this year, we published a comprehensive Investor Alert titled “Auction Rate Securities: What Happens When Auctions Fail.” We issued this alert to let investors know—in plain English and without industry jargon—about some of the options available to them in the event their ARS investment becomes illiquid. We also wanted investors to better understand that when an issuer makes a call for a partial redemption, they may not always get to participate in the redemption.

The Investor Alert outlined the alternatives available to ARS investors who want to liquidate their holdings—but cannot because of failed auctions. We explained to investors that they could: continue to hold ARS investments, borrow on margin, liquidate other investments and sell in the secondary market. Because some of these options could impact their investments or trigger tax consequences, the alert also urged investors to consult with financial advisors or accounting and tax experts before choosing any one option.

The Alert also tells investors where to turn for additional help, including where to obtain a copy of the offering documents for their ARS investments and how to file an online complaint related to auction rate securities.

This particular Alert is just one of an ongoing series of investor education materials continually prepared and updated by FINRA. Using the Internet, the media and public forums, we help investors build their financial knowledge and provide them with essential tools to better understand the markets and basic principles of saving and investing. We issue alerts to inform investors about potential problems and provide plain English explanations of products and processes. In addition, we have developed a variety of interactive tools for investors to use in making financial decisions. Some of these tools allow investors to analyze mutual fund expenses, calculate savings needed for college expenses, and plan for future retirement. FINRA also reaches out to investors through public education events across the country.

In addition to the investor education activities of FINRA itself, the FINRA Investor Education Foundation (FINRA Foundation) is the largest foundation in the United States dedicated to investor education. The Foundation seeks to provide underserved Americans with the knowledge, skills and tools necessary for financial success throughout life. To further this mission, many of the Foundation grants and educational programs carefully aimed at specific segments of the American public who could benefit from additional financial education resources—such as seniors, nurses, and military personnel and their families. Other initiatives, such as our public library program, *smart investing @ your library*, serve the public at large. Since the FINRA Foundation's inception in December 2003, it has approved more than \$33 million in financial education and investor protection initiatives through a combination of grants and targeted projects.

Dispute Resolution

On August 7, in conjunction with the SEC's announcement of its settlements, FINRA announced the establishment of special arbitration processes for auction rate securities cases administered in our arbitration forum.

Under FINRA's current arbitration rules, ARS cases in which damages claimed are under \$50,000 will continue to be heard by a single public arbitrator. Also pursuant to current rules, ARS cases in which damages claimed are over \$50,000 will continue to be heard by a panel consisting of two public arbitrators and one non-public arbitrator. However, the non-public arbitrators in these cases will not be individuals who, since Jan. 1, 2005, have either worked for a firm that sold auction rate securities or themselves sold or supervised someone who sold auction rate securities.

FINRA updated its arbitrator biographical information and computer systems so it could easily identify arbitrators who are ineligible to serve in auction rate cases under the new process. We have contacted all parties in pending auction rate securities cases to inform them of the new process and its impact on their case. FINRA worked expeditiously with parties to put this process in place so that these cases were not unduly delayed.

The new panel composition process will also apply to any new arbitrations involving auction rate securities, except those filed pursuant to regulatory settlements. FINRA is also developing special arbitration procedures for claims of consequential damages filed by customers of firms that have entered into regulatory settlements. Detailed procedures are still being finalized, but in accordance with the settlements, a claimant can choose to

have a single public arbitrator decide those cases irrespective of the amount claimed, and the firms will be responsible for all administrative fees of the arbitration.

To date, more than 225 arbitration cases involving auction rate securities have been filed in FINRA's Dispute Resolution forum.

Conclusion

FINRA has employed a comprehensive and integrated response to the recent challenges in the auction rate securities markets. First and foremost, we are using our regulatory, surveillance and enforcement tools to detect and deter abusive sales practices in the ARS markets. We have close to 50 enforcement inquiries in this area that are active and ongoing. We are also working to educate investors to help them make the best financial decisions for their unique situation, and have established a special forum to fairly and expeditiously resolve investors' auction rate securities-based claims. FINRA will continue to aggressively pursue possible violations by firms and will continue to work with this Committee and our regulatory counterparts to advance our essential investor protection mission.

Thank you again for this opportunity to discuss these important issues. I would be happy to answer any questions you may have.